



State of Washington

## DEPARTMENT OF FINANCIAL INSTITUTIONS

DIVISION OF CONSUMER SERVICES

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**November 21, 2006**

### **Concise Explanatory Statement**

Pursuant to RCW 34.05.325(6)

Rulemaking on Regulating Mortgage Brokers and Loan Originators

(2006 Amendments to the Mortgage Broker Practices Act, chapter 19.146, RCW)

### **Background**

Engrossed House Bill 2340, signed into law on March 9, 2006, made significant changes to the Mortgage Broker Practices Act (MBPA), chapter 19.146 RCW. Under the authority granted by chapter 19.146 RCW, and EHB 2340 (chapter 19, Laws of 2006), the Department of Financial Institutions (DFI) proposed repealing the existing rules and replacing them with rules that reflect the changes made to the law, and changes in the rapidly changing residential mortgage loan industry.

### **Negotiated Rulemaking**

Because of the significant changes contemplated, DFI chose negotiated rulemaking with the mortgage broker industry as the best vehicle to draft new rules. DFI began the negotiated rulemaking by convening a rules drafting panel consisting of DFI's consumer services division director, DFI staff, and five mortgage brokers from the Mortgage Broker Commission representing different segments of the mortgage broker industry regulated by DFI<sup>1</sup>. The mortgage broker panel members chaired working groups (sub-panels) for licensing, examinations, enforcement, and a miscellaneous sub-panel. The sub-panels also included DFI staff from the different subdivisions. The sub-panels drafted proposals, the proposals went to the full panel for review, and if approved at the full panel level, became a final proposed rule. The sub-panels met bi-monthly, weekly, or as needed, and DFI held eleven full panel public

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<sup>1</sup> Chuck Cross, Director, Division of Consumer Services, DFI; Catherine Mele-Hetter, Policy Director, DFI; Adam Stein, President, Mortgage Broker Commission, Rich Bennion, Homestreet Bank, Commissioner; Jeff Berglund, Morgan Mortgage, Commissioner; Laura Kiel, Kiel Mortgage, Commissioner; Jeff Lorsch, Evergreen State Mortgage, Commissioner.

meetings. The first full panel meeting was held on March 30, 2006; the last on August 9, 2006. Each full panel meeting was open to the public and as each draft of the proposed rules was prepared for review, DFI posted it on DFI's website for public review and comment. At each full panel meeting, the current version of the draft rules was discussed and the draft rules were approved, modified, or sent back to the sub-panels for additional work. The changes from each draft to the next were marked so that any person reading the draft rules from panel meeting to panel meeting would see the changes that resulted from the full panel's review. Public comments to the proposed rules were taken at each full panel meeting. Additionally, at each meeting, the panel responded to all written comments received since the last panel meeting by reading the comments into the record, discussing the comments, and taking appropriate action on the comment, usually by sending the comment to one of the rulemaking sub-panels for research or rule drafting. During the drafting process DFI's website posted the current version of the draft rules, a comment form for public comments, the date and location of future panel meetings, and all prior panel meeting materials including agendas, prior drafts of the rules, minutes from each meeting, comments received on the rules, and an audio recording of each meeting.

### **Small Business Economic Impact Statement (SBEIS)**

Under the Regulatory Fairness Act, chapter 19.85 RCW, DFI assessed the proposed rules' impact on small businesses. In order to make this assessment, DFI developed a survey for mortgage broker licensees. The draft survey was presented to the full panel at the June 15, 2006 meeting. The draft was also posted on DFI's website. The final survey was available for online completion by interested parties on the DFI website, or by paper copy upon request, from June 27, 2006 to July 15, 2006. DFI received 215 responses to the online survey and three responses via paper copy of the survey.

DFI compiled the survey results and prepared the final SBEIS which was filed on September 5, 2006 as part of the CR-102, published as WSR 06-18-067. In the final SBEIS report, DFI detailed each mitigating step taken by DFI under each topic to lessen the impact, if any, of the proposed rules on the industry.

### **CR-102 Phase**

On September 5, 2006, DFI filed the CR-102 with the Office of the Code Reviser. The filing consisted of the CR-102 notice, the final proposed rules, and the SBEIS. The CR-102 was distributed through the Washington State Register on October 4, 2006, under notice number WSR 06-18-067. DFI mailed the CR-102 notice and an additional informational letter to approximately 3,500 interested parties and licensees. The CR-102 notice, final proposed rules, SBEIS, and the date and location of the public hearing were posted on DFI's web site. DFI scheduled the public hearing on the final proposed rules for October 26, 2006, in Olympia.

At the recorded public hearing on October 26, 2006, DFI took oral testimony from nine participants. Also at the hearing, DFI read into the record and responded to five comments received by the department between August 8, 2006 and the hearing. These comments were

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either substantive in nature or concerned a unique topic not previously addressed during the rulemaking process. Finally, DFI extended the public comment period to 5:00 PM, October 31, 2006. The oral and written comments from the public hearing are detailed below.

**Statutory Requirements:**

**Agency reasons for adopting the rules.** RCW 34.05.325(6)(a)(i).

The significant legislative changes to chapter 19.146 RCW by EHB 2340 in 2006 necessitated a comprehensive review and revision of the existing rules. Additionally, the existing rules had not been revised since 2001 and the mortgage broker industry recommended changes to keep pace with the rapidly changing residential mortgage loan industry. Finally, the final proposed rules implement the Governor's Executive Order (Executive Order 05-03) on following the Plain Talk method of rules writing.

The MBPA gives DFI broad administrative authority to administer and interpret the provisions of the chapter to "promote honesty and fair dealing with citizens and to preserve public confidence in the lending and real estate community." RCW 19.146.005, 223.

**Describe differences between the text of the proposed rules as published in the Washington State Register and the text of the rules as adopted, other than editing changes, stating the reasons for differences.** RCW 34.05.325(6)(a) (ii).

None.

**Summary of and response to comments received by DFI during the negotiated rulemaking process from March 30 to August 8, 2006.**

During the negotiated rulemaking, numerous comments were received on the following topics. Consequently these subjects were discussed extensively at the full panel meetings, often with attendees joining in the conversation, or featured speakers providing information at the request of panel members. The topics and DFI's responses are summarized below:

Mortgage Brokers: Annual report of number of and dollar volume of loans – There were several comments expressing concern that this new reporting requirement would create a hardship for mortgage brokers because it would result in new recordkeeping requirements. However, licensees already collect and maintain the information necessary to comply with this reporting requirement; they have just never had to produce it in the form of an annual report to DFI.

DFI originally proposed to have the mortgage industry report a substantial amount of information in their annual report. When significant opposition arose, DFI agreed to an annual report containing only the total number of residential mortgage loans made by the mortgage broker and the total dollar value of those loans.

Designated Brokers: Frequency of testing under the new law – This topic generated many comments. Many of the comments advised a testing scheme that would “grandfather in” anyone having passed the mortgage broker license examination prior to January 1, 2007. The commission members on the full panel felt that passing the examination alone was not sufficient; a person must also have worked as a designated broker for a period of time, or at least recently. This led the panel to consider various combinations of a passing examination score plus work experience.

After considerable discussion, the full panel made a decision that included the examination and experience. DFI concurred in the full panel decision, and the decision is reflected in the final proposed rules.

Responsibility of the Designated Broker to oversee loan originators and company activities - This topic was debated during the drafting of the amendments to the MBPA and loan originator licensing was one result of those discussions. DFI received many comments in support of loan originator licensing.

The final proposed rules incorporate both the pre-rulemaking process (the discussions during amendments to the MBPA leading to loan originator licensing) and the decisions made during the rulemaking process following full panel discussions and the opportunity for public comment. The final rules provide notice and guidance to designated brokers of their responsibilities under the MBPA.

Loan Originator Licensing – Most of the public comments and panel discussion of this new requirement involved the license fee, the licensing of loan originators working for exempt mortgage brokers, test topics, continuing education requirements, whether loan originators should work for more than one mortgage broker, and the process for licensing loan originators who originate loans for more than one mortgage broker.

The final proposed rules were developed by the full panel after discussion and consensus on the issues.

### Examinations

The new law provides the authority for DFI to examine mortgage brokers within the first five years of licensing. The process of the examinations generated a great deal of concern in the industry as voiced by the commission members.

In response, DFI developed and made available on its website a draft of the Mortgage Broker Examination Manual, drafted by DFI examination staff as a step by step guide for DFI examiners for use on the job. DFI made the manual available in order to help the industry by describing what DFI examiners will look for in an examination. The manual contains many helpful forms for compiling information that licensees can download and incorporate into their recordkeeping process. Mortgage brokers can also use the examination manual to guide outside certified professionals if they choose to hire a certified professional to conduct an examination of the business in lieu of DFI conducting the examination. Many initial examinations will be technical assistance examinations, focused on educating the licensee about recordkeeping for compliance with state and federal law. To further mitigate the impact of the new examination program on mortgage broker licensees, DFI plans to provide outreach and education to help prepare licensees for their examinations. Outreach and education will include the examination manual, discussions of the examination process, descriptions of the records required during the

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examination, a description of the common errors made by licensees in keeping records, an explanation of the examination report, and what action licensees must take in response to an examination report.

Additionally, two mortgage broker panel members volunteered to have DFI conduct an examination of their businesses during the rulemaking process to test the examination process described in the newly developed manual. The two panel members who volunteered their businesses for the examinations reported favorably on the process at the public hearing.

Continuing Education – the comments and discussions of this topic concerned the number of annual continuing education credits required for designated brokers and loan originators, and who would provide the continuing education. The panel discussed the number of credits and decided on an annual number for designated brokers and loan originators. The final proposed rules reflect that decision.

DFI originally proposed that continuing education would be provided only by professional organizations. However, because of concerns raised by individuals in the business of providing continuing education, DFI decided that in addition to approving professional organizations to offer continuing education, DFI will continue to approve continuing education courses offered by individual providers.

**Summary of and response to oral comments received at the public hearing, October 26, 2006.** RCW 34.05.325(6)(a) (iii).

DFI received nine oral comments to the final proposed rules during the hearing. Eight of the nine speakers spoke in support of the rules. Four of the speakers also had questions or concerns about the final proposed rules which are summarized below:

**Question/Comment 1:** This person raised concerns regarding WAC 208-660-300, Sections 5, 8 and 9. Their first concern was that an independent loan processor would be required to be licensed as a loan originator but then would not be allowed to charge fees. The person indicated they thought the intent when the rule was written was that all money would pass through the mortgage broker. The person requested clarification on whether the rules require that an independent contractor loan processor would have to be paid by the mortgage broker and the money would travel through their trust account. Regarding Section 8, the person asked whether the rules prohibited a loan originator from hiring clerical or administrative personnel whose work is related to the licensed mortgage broker activities and loan processors. The person commented that the rules seemed to be painting with a broad brush to not permit an independent contractor loan originator to have a secretary or receptionist.

**Response:** The rules do require some loan processors to be licensed as loan originators. A loan processing company may be licensed as a mortgage broker and then would be allowed to charge fees independently of the mortgage broker who originated the loan. The rules would require that the fees charged by the loan originator licensee would pass through the mortgage broker trust account under whose license that loan originator is designated to operate. To the second comment, an independent contractor loan originator cannot hire employees or independent

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contractors. The statute is clear: the licensee takes responsibility for the violations of people acting under that license but not for people disconnected down the line from there. An independent contractor loan originator's violations are under the mortgage broker's license but the violations of another independent contractor downstream from there are not. We had to sever it at that point to make sure that everybody doing business under the act is covered under the mortgage broker licensee and bond.

**Question/Comment 2:** This comment concerned a situation where a designated broker wants to originate a loan on his or her own behalf but they are the only licensee in the company. Because this issue is not addressed in the rules, the commenter would like DFI to do an interpretive letter providing guidance in this situation.

**Response:** The department recognizes the complications created by the licensing structure and how this might impact small companies in this way so our intent is to issue an interpretive letter clarifying this to coincide with implementation of the statute and the rules.

**Question/Comment 3:** This comment concerned the location of a loan processor's loan files under different licensing scenarios. Another question concerned the licensing process for someone who worked for more than one mortgage broker. Finally, the person asked about DFI's view of a company that was 100 percent paperless with all files kept electronically.

**Response:** If a loan processor holds a mortgage broker license, the original files could reside with that loan processor. DFI would require a copy or ghost file to remain with the originating licensee. A licensed loan originator working as an independent contractor can only take loan files out of the mortgage broker office to go to a branch office of that mortgage broker. For independent contractor loan originators, the rules provide two choices for where the files must be kept. One choice is for the records to stay at the office of the licensed mortgage broker originating the loan. If a person worked as an independent contract for more than one mortgage broker, they would have to go to each office to do the processing activity, leaving the files there. In the alternative, the independent contractor's office could be a branch location of one or more main offices of the licensed mortgage brokers. The bottom line is that the rules do not allow a licensee to take the files away to an unlicensed location. Licensed loan originators still have to work from a licensed location. Finally, DFI is very receptive to the type of technology where we can reduce paper consumption, and the rules are not intended to restrict licensees from keeping proper records in an electronic format.

**Question/Comment 4:** This person expressed concern that by implementing a centralized electronic location for loan originators to access loan files to improve compliance, it would give the loan originators the ability to work from any terminal in the world.

**Response:** The final proposed rules have not changed from the existing rules on this issue. The burden is on the licensee to make sure their employees are not setting up in unlicensed locations now that they have the technology to do so.

**Summary of and response to written comments received by DFI during the public comment period, October 4, 2006 through October 31, 2006.** RCW 34.05.325(6)(a) (iii).

**1. Requests for Information:**

DFI received requests for information about the proposed rules throughout the comment period. Most of the requests were for information about the upcoming licensing requirements for loan originators. Other requests for information were about changes to designated broker requirements, the process for meeting the continuing education requirements, and the process for mortgage brokers licensed out of state to become licensed in Washington.

**Response:** DFI staff responded to each individual request for information upon receipt of the request.

**2. Requests about Applicability of Final Proposed Rules:**

DFI received requests for information about the applicability of the final proposed rules on exempt licensees and loan processors.

**Response:** DFI staff responded to each individual request for information upon receipt of the request.

**3. Substantive Questions/Comments on the Final Proposed Rules:**

**Question/Comment 1:** The commenter wanted to know if WAC 208-660-350 (26) also applied to mortgage brokers originating loans. The commenter was concerned that including a mortgage broker or loan originator license number on all correspondence would be a significant initial cost to all brokers and loan officers to get their paperwork ready for the new rules on January 1, 2007.

**Response:** The rule does require loan originators to include their license number on solicitations, including business cards, advertisements, and loan applications. The licensing of loan originators is a significant change in the law, one of the goals of which is to provide the public the opportunity to know who a loan originator is working for and the fact that they are actually licensed. Licensees should be aware that in 2008, Washington intends to begin using the national database for mortgage broker and loan originator licensing. At that time, all mortgage brokers and loan originators will be issued new license numbers. As a result, DFI urges licensees to be aware of this upcoming change when deciding to print advertising material and business cards in 2007. This issue was also addressed in the SBEIS.

**Question/Comment 1.1:** The commenter wanted to know why WAC 208-660-410 (16) and (29) required a mortgage broker to deposit into the trust account funds from a third party, such as a closer or a lender, as reimbursement for advancements for the payments of third-party services. The commenter felt this accounting requirement does not serve a useful purpose.

**Response:** The department notes this concern about the complexities of trust accounting. The trust accounting rules, while transferred into the clear rules writing format, are largely unchanged from the rules that have been in place for over ten years. Washington has significant trust accounting requirements the violation of which are a Class C felony. As a result, the rules include very specific requirements for being in compliance with the act.

**Question/Comment 1.2:** The commenter wanted WAC 208-660-350 (37) to include an intent element so that a mortgage broker who intended to commit fraud using the trust account would be punished with a Class C felony, but a mortgage broker who made an administrative error would not be punished with a felony offense.

**Response:** The legislature wrote the criminal penalty section of the statute and the rules cannot make less of a violation than the legislature intended. Frequently, licensees argue that it was never their intent to commit a violation and they also frequently argue ignorance of the rules and law for their defense. However, the legislature did not include a requirement to prove intent in this section, and therefore, DFI has no authority to add this element into the law by adopting a rule.

**Question/Comment 1.3:** The commenter noted that escrow software programs often referenced mortgage broker fees outside of the range of lines 808-811, the lines required in the new rules. The mortgage broker would be punished for something over which they have no control.

**Response:** The escrow industry has indicated to us they have no problem showing mortgage broker fees on lines 808-811. The only time the fees end up on lines 801 and 802 is when forced by the mortgage brokers. The information received by DFI indicates that putting these amounts on the correct lines is not a problem for escrow agents to accomplish.

**Question/Comment 2:** The commenter suggests an alternate licensing scheme for loan processors that will enable contract processors to process loans for any mortgage broker in Washington without having to be licensed or be a branch of each mortgage broker they work for. The commenter feels this option makes sense and will enable self-employed contract processors/business owners to continue to earn income and support their families while growing their businesses and also providing a valuable resource for mortgage brokers.

**Response:** The legislature, through the changes to the act, determined who in the mortgage broker industry is required to have a license. DFI cannot through rule create another level of licensing for loan processors. DFI recognizes the complications created by the licensing structure and how this might impact small companies in this way.

## **CONCLUSION**

The final proposed rules are appropriate and necessary given the extensive amendments made to the MBPA by the legislature through EHB 2340, and by the changes in the mortgage industry since 2001. The final proposed rules are the product of a negotiated rulemaking process open to

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public review and comment. To make the process as open as possible, DFI notified the regulated industry of the rulemaking and its progress by posting rule drafts and other information on its internet website. Additionally, public comments were taken at each of the eleven panel meetings, as well as at the public hearing on proposed rules held on October 26, 2006. The rulemaking panel, consisting of practicing mortgage brokers, proposed language and discussed, reviewed, and revised the proposed rules throughout the process. The final rules are the product of this open, deliberative process.